Global Counsel

Will India's political monsoon season drown the next push for reform?

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Summary

- Ministers, the media, business leaders and the civil service in India openly describe 2011 as the worst year for governance in India's recent history and a political inflection point in the seemingly unstoppable upward trajectory of the last decade.
- The pressure is now on the UPA Coalition Government to reassert its ability to govern, and to produce a strong electoral platform for the state elections in 2012 and national elections in 2014. The coalition has other things on its mind.
- For Indian corporates, the politics are deeply frustrating. Although the prospects for organic expansion in the coming 6-12 months are good, many Indian companies are looking outward from India, both to mitigate political risk and for diversified growth and sources of technology.
- India is a country of low patience and huge expectations. High growth has raised popular Indian expectations to a point that the economy is not structurally able to deliver at present. Populist politics help ensure that the development dividend and the expectation gap are simply addressed by subsidies and forms of social welfare prone to corruption and other leakages.
- For now, the Indian system seems to prefer to wait. Its economy will continue to grow. It has demographics broadly on its side, if it can continue to create jobs. But the risk of political immobility means that India's latest stumble could be a sign of things to come.

The Indian Parliament returned on Tuesday 22nd November for its Winter session. After a Monsoon session in August that descended into chaos responding to the Anna Hazare anti-corruption movement, the pressure is now on the UPA Coalition Government to reassert its ability to govern, and to produce a strong electoral platform for the state elections in 2012 and national elections in 2014. This looks a huge ask for a Congress Party increasingly pre-occupied with thoughts of a new leader; and with an opposition pursuing a course of deliberate obstructionism, yet weak and failing to provide much external, unifying pressure on Congress.

Speak with people at the top of both regional and national decision making and the clear impression is of a system that is undergoing a crisis of confidence. While people are more positive outside the orbit of Mumbai elites, even traditional optimists are reflecting that important reform issues – energy supply and pricing, urbanisation strategies, land acquisition, and water – are in danger of stalling, with potentially serious consequences for India's economic growth.

Ministers, the media, business leaders and the civil service openly describe 2011 as the worst year for governance in India's recent history and a political inflection point in the seemingly unstoppable upward trajectory of the last decade. Before the financial crisis there was a confident assertion both among Western analysts and Indian business and government that a golden age for India was arriving. This Global Counsel Insight note looks at how political constraints have the potential to start to take the shine off India's growth story.

India's political monsoon season

If you were looking for a European analogy for Indian Prime Minister Manmohan Singh, new Italian Prime Minister Mario Monti would come close. Singh is subtle, cerebral and essentially technocratic. But the man praised for the 1991 reforms, which helped unlock the growth rates of the 2000s, is often now routinely described as stymied by the chaotic politics of the UPA and the chronic problem of asserting a coherent national programme. Finance Minister Mukherjee is the key wielder of practical power. The extreme sensitivity within the UPA about overshadowing Congress Party leader Sonia Gandhi means that even Singh's achievements are downplayed. With Singh embattled and the ever-present 'Mrs G' contending with personal health issues, there is a conspicuous leadership deficit.

Of Rahul Gandhi's accession to the leadership, the question appears to be when and how, not if. He is biding his time, building ideas, accumulating allies, and avoiding any appearance of presumption. He has yet to define his approach to economic policy, caught between the rural appeal and social populism of his mother, Sonia, and the economic agenda of his father, Rajiv. He has yet to persuade the older generation that he has what it takes to lead.

The opposition Bharatiya Janata Party (BJP) has meanwhile failed to recover from its defeat in 2004. It is more concerned about seizing back power than about defining a distinctive policy agenda, content to rely on grievance politics and throwing grit in the wheels of government. The recent corruption scandals, notably the on-going investigations into the sale of 2G spectrum, have bought this into sharp relief, seized upon and amplified to damage the Congress Party. Internally, three or four groups are forming within the BJP, each focused internally on their own future leadership candidates. But the net result of this is policy inertia and little real attempt to define an effective, competing vision for India.

The implications of this dynamic for the India's economic development strategy are potentially wide-ranging. Much of India's economic and fiscal reform agenda requires a counterbalance to the populism of grassroots politics. This needs political leadership willing and able to negotiate difficult compromise and change with the interests of India's agricultural poor. Sonia Gandhi's traditional rural base already acts as a check on the kind of technocratic agenda Singh was able to drive through in the 1990s. If the large state elections - critically, in Uttar Pradesh, Gujarat and Punjab – do not go Congress' way in 2012, then there is a strong likelihood that the momentum behind reform will dissipate altogether, at least until after the elections of 2014, replaced instead with a raft of expensive populist measures.

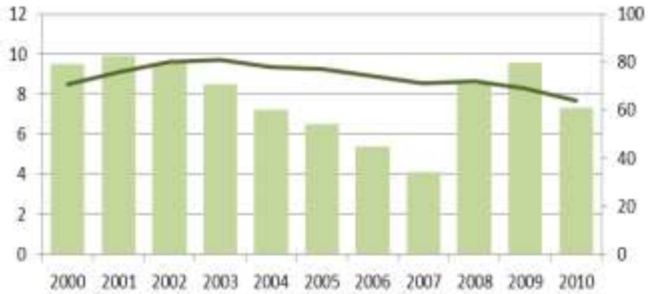

Chart 1: Indian general government debt (RH) and deficit (LH), %GDP.

Source: Reserve of Bank of India

For Indian corporates, the politics are deeply frustrating. Although the prospects for organic expansion in the coming 6-12 months are good, many Indian companies are looking outward from India, both to mitigate political risk and for diversified growth and sources of technology. Despite a long track record of successful investment in Europe (notably the UK, Germany and France), Indian business is regarding the Eurozone situation with bemusement and increasing concern. The EU-India Free Trade Agreement continues to be negotiated, but it requires stronger and immediate political backing to stand a chance of being concluded in time for the EU-India Summit on 10th February 2012.

Politics and the dividend from Indian growth

The underlying realities in India remain daunting. India's high growth rate, which had exceeded 9 per cent in 2006/07 and 2007/08 driven mainly by private investment and consumption, is now forecast to fall below 8 per cent this year. Fourteen consecutive rate rises by the Reserve Bank of India (RBI) have not addressed the underlying drivers of inflation, chiefly because these are rooted in domestic food price fluctuations, government wage guarantees and a combination of fiscal stimulus and persistent fiscal overspend. They have, however, acted as a brake on growth.

There has always been a lot of talk about the move from the 1970-80s 'Hindu' growth rate of 2-3 per cent to a more buoyant rate between 7-9 per cent in the 2000s. It is no less important to ask why India has run persistent average 8 per cent deficits since 1992 (Chart 1). This is a question that goes to the heart of its political economy and the recent troubles. Fifty-seven per cent of India's 450 million work force is employed in the agricultural sector, a sector that contributes just 15 per cent to GDP and in which employment is often indistinguishable from subsistence poverty.

The sector needs massive consolidation and modernisation to improve its productivity, lower India's reliance on food imports and encourage people to move into new work in the manufacturing sector. The recently announced National Manufacturing Policy recognises this, with a stated objective to create 100 million new manufacturing jobs, and boost manufacturing from around 16 per cent to 25 per cent of India's economy. Policy-makers, however, recognise that this is a highly aspirational target. The lauded services sector makes up 57% of GDP, but it is not the panacea for the population's employment needs.

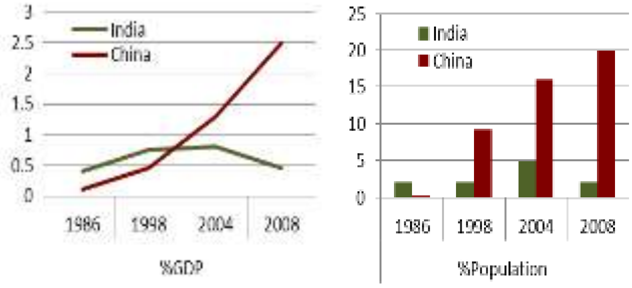

Chart 2: Income tax as a % of GDP, and share of population borne by, India and China

Source: Piketty and Qian 2009

If India was ever the caricatured country of huge patience and low expectations, in 2011, it is a country of low patience and huge expectations. High growth has raised popular Indian expectations to a point that the economy is not structurally able to deliver at present. Indian rural workers expect a dividend from rapid Indian growth, but are not being sufficiently assisted in the transition to industrial employment that would enable this dividend to be delivered in the form of jobs and pay. Indeed, policy responses like the National Rural Employment Guarantee Scheme are entrenching the problem rather than addressing it. Instead, populist politics help ensure that the development dividend and the expectation gap are simply addressed by subsidies and forms of social welfare prone to corruption and other leakages.

Politics, however, is also a check on the will of politicians to raise either the income and consumption tax burden needed to meet India's social welfare and infrastructure investment demands. Income tax is still an elite tax in India, paid by less than 2% of the population (in stark comparison to China, where it has quickly become a mass tax and an important pillar of government revenues in the last two decades. See Chart 2). The Indian government has in fact consistently moved tax bands to ensure the income tax burden has remained focused on a tiny stratum of Indian society. The mandatory lending to government imposed on Indian banks helps fund the resulting deficit cheaply and stably, but it is also a disincentive for reform and is sucking resources away from lending to the real economy and important infrastructure investment.

Where next: short-term risk, medium-term upsides

A pragmatic assessment suggests that incremental reform will continue to happen. On 22nd November, the Cabinet approved a paper allowing FDI in multi-brand retail, increasing the permissible holding from 49% to 51%, albeit with conditions attached requiring sourcing of 30% of produce from local small and medium sized enterprises. This proposal has crawled through Cabinet, but its rational arguments for a form of liberalisation that will help bring Indian produce to market faster and reduce exceptional levels of waste in the Indian food supply chain were not ignored. The final version is emblematic of the current Indian approach: a valuable concept compromised by political tradeoffs.

Looking ahead, the National Planning Commission's Framework for 12th Five Year Plan (2012-17) recognises the need for $1 trillion of spending on infrastructure over the period. The aim remains to secure fifty per cent of this through private funding. While the RBI sees this as an excessive risk, the government seems determined to deliver, with proposals progressing to develop a long-term debt market and building on signs of confidence to allow higher levels of foreign inward investment flows. At the same time, however, these critical infrastructure projects depend on the current sensitivity to corruption. This reinforces the bottlenecks, but strong action by government, the independent auditor (the Comptroller and Auditor General, who is highly regarded), the Central Bureau of Investigation, and judiciary should prove beneficial and relieve India's practice of corruption in the medium term, as projects will be delivered more effectively, with fewer hold ups and losses.

It is in the nature of India that the recent corruption scandals and the public reaction are, in a way, seen as a badge of pride. They are a clear demonstration of the vitality of Indian civil society, free media and dissent. The same aggressive scrutiny, however, can also act as a check on bureaucratic decisiveness as officials are nervous of media attention and cautious about signing off official advice. At best, the scandals of 2011 and the political response will be a cathartic moment for the Indian system; at worse, they will lead to continued paralysis in the machinery of government.

The democratic nature of the India's political system has rightly always been held up as the key to the legitimacy of its development strategy. At this point, it also resembles an excuse not to have one. In some respects, the structures of Indian business are also not always pulling in the direction of high-quality job creation and economic diversification. For all the dynamism of Indian business, a lot of large Indian corporates are still built around essentially nepotistic models that are as inclined to rent seeking as much as job creation – and encouraged by subsidy and corruption to be so. Transforming India's latent entrepreneurialism into sustained enterprise and job creation in a new generation of small and medium sized firms will be key to its progress.

For now, the Indian system seems to prefer to wait. Its economy will continue to grow. It has demographics broadly on its side, if it can continue to create jobs. It has no appetite for the advice or strictures of the Western economies. But the risk of political immobility means that India's latest stumble could continue to prove damaging. How the government responds in the current parliamentary session and in the run up to the Budget and next Five Year plan in early 2012 will determine the extent of the damage and how long it will last.

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